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301613Z Sep 03

UNCLAS SECTION 01 OF 03 ANKARA 006141

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SENSITIVE

TREASURY FOR OASIA - MMILLS AND JLEICHTER
STATE FOR E, EUR/SCE, EB/IFD/OMA AND EB/IFD/ODF
NSC FOR MBRYZA AND TMCKIBBEN

E.O. 12958: N/A
TAGS: EFIN PREL TU
SUBJECT: KEY ECONOMIC CONDITIONALITY ISSUES FOR USG LOAN DISBURSEMENT

REF: A. ANKARA 5951
¶B. ANKARA 6071

¶1. (SBU) Summary: For the decision on GOT compliance with economic conditionality in the U.S.-Turkish Financial Agreement, post recommends Washington focus on the most critical issues in the IMF's Sixth Review: staff reductions at SEE's, the end-August fiscal target, the 2004 budget, the Public Financial Control Law, Direct Tax Reform, strengthening the Bank Regulator's ability to seize intervened banks' owners' assets, and GOT approval of a plan to privatize Turk Telecom. We are not likely to have enough information to judge whether the GOT is on track until the IMF mission completes its work around October 10. Separately, Post recommends the USG lay down markers for a different set of issues we will scrutinize in making our decision six months hence on a second tranche disbursement. End Summary.

Critical issues for First FA Disbursement:

¶2. (SBU) In order to prepare for the U.S. decision on the GOT implementation of &strong economic policies8 as required under the Financial Agreement (FA), post recommends the USG concentrate on a few key issues. These are all requirements (either prior actions or structural benchmarks) for the IMF,s Sixth Review. Though there are other requirements of the Sixth Review, post recommends we focus in particular on these because they are critical to long-term success of the program (e.g. fiscal adjustment) or because they demonstrate strong political will to continue reforms (e.g. reducing staff at SEE,s).

¶3. (SBU) Post recommends we focus on the following:

--End-August fiscal target: Though we do not yet know whether the GOT met the end-August primary surplus target, it is likely to have fallen somewhat short. A key issue would be then be the GOT elaborating with the Fund a series of remedial actions to meet the end-year fiscal target. We will also need to decide how much importance to attach to the GOT missing the target, even if it came close.

--Credible 2004 budget: By law, the government must submit its 2004 budget by mid-October. Government agreement with Fund Staff on a credible 2004 budget, in line with 2004 primary surplus targets, is vital to sustain the economic reform program and maintain market confidence.

--Progress on SEE staff reduction: Unless there have been significant additional actions in recent days, by the end of September the GOT will have reduced the number the number of redundant SEE employees by only 11,000, far from the 19,000 end-September target. The key will be whether the government has had the political will to lean on the SEE managers to further reduce staff in late September and October. Given the high likelihood of this target being missed by a wide margin, here, too, we will want to see how the Fund deals with this issue and to decide for ourselves how much weight to attach to the shortfall.

--Passage of the Public Financial Management and Control Law: Though this is less politically controversial, it is important to improve the transparency of the budget process, and to enforce centralized control over line ministry

spending. This law will also help maintain the autonomy of the independent regulatory bodies such as BRSA, since parliament--rather than the executive branch--would approve the independent bodies, budgets. The law would also bring extra-budgetary spending into the budget framework.

--Direct Tax Reform: Though the Sixth Review does not require passage of the Direct Tax Reform, it does require GOT agreement with the Fund on the specifics. It remains controversial and politicized, with considerable GOT resistance--up to the Prime Minister--to eliminating all the regional tax incentives. IFI officials have told us that public statements by the Prime Minister in favor of regional incentives have translated into GOT insistence that there be some form of regional incentive. Fund staff are reportedly working on a &least-bad8 compromise.

--Passage of legislation to strengthen the BRSA's hand in dealing with court cases involving problem Banks: It has been prepared but parliamentary passage will also be needed for the Sixth Review.

--Privatization: The Sixth Review requirement of approval of a plan to privatize Turk Telekom would seem to be a minimum requirement for the USG. Unless the Fund mission currently in country fails to clinch agreement on a Letter of Intent, neither the Petkim, Tupras, or Tekel privatizations will have reached their bid-submission dates by the time the U.S. needs to decide whether to disburse. Consequently, the only reasonable privatization measure we could insist on would be the Council of Ministers approval of a plan to privatize Turk Telekom.

¶4. (SBU) Post does not repeat not recommend emphasizing the targets for inflation and monetary policy, or for growth.

Compressed Timing Dilemma:

¶5. (SBU) Post will confer with key GOT economic technocrats and Fund Staff this week to hear how well the GOT is progressing on reform implementation, particularly those pertaining to the Sixth Review, and will provide ists assessment of progress by October 6. Washington should note, however, that there is a real possibility that the USG will not have enough information to determine whether the GOT is on track by October 6. In fact, the status will probably not be clear until the IMF team completes its work. Between now and October 6 the above-cited legislation may not have been submitted to parliament--let alone passed--and there may be little news on the fiscal targets, SEE's, direct tax reform and Turk Telecom.

Potential Markers for the Second Tranche:

¶6. (SBU) Given the timing of the disbursement decision on the first tranche of the FA, it seems unrealistic to push for more reforms than those in the Sixth Review. Post recommends, however, that we lay down markers--either before or after disbursement--about progress we,d like to see before the second tranche, including not only staying on track with the Fund program but possibly a broader array of reforms which the GOT has committed to implement:

--Privatization: With Petkim, Tekel and Tupras nearing bid submission, post believes it is reasonable to make the point now that the USG expects the GOT to consummate the sales of all three of these companies by the time of the second tranche. In addition, without requiring a sale, there should be tangible signs of progress in restructuring and preparing state banks for privatization, such as approval of a strategy for Vakif Bank.

--SEE staff reduction: Complete year-end staff reduction targets on SEE,s not on the privatization list (in other words, eliminate all 19,000 positions). Note that privatization of Petkim, Tupras, and, especially, Tekel, will take care of position-reduction targets at SEE,s on the privatization list.

--2004 budget measures: pass a budget which is in line with the agreement with Fund staff. In the past there have been problems with slippage between agreement-in-principle with the Fund and the actual measures passed. We would also expect year-end and first quarter fiscal performance to be in line with IMF-agreed primary surplus targets. We could

stress the need for sustainable, rather than one-off, revenue measures.

--Maintenance of the independence of regulatory bodies: Since the GOT is currently considering a law that would undermine the independence of these institutions, this would be an important signal to send.

--Progress on sectoral reforms in energy, telecoms and agriculture: These issues, on which progress has been very slow, are the centerpiece of the World Bank,s efforts in Turkey. The GOT has been particularly slow to take advantage of World Bank financing by implementing these reforms. Given the complex and difficult nature of these sectoral reforms, post recommends making a general point about wanting to see progress, rather than requiring anything too specific, with one exception. In the telecoms sector, post recommends a marker on the GOT implementing its WTO commitment to liberalize fixed telephony on January 1, 2004. Post believes the telecoms sector in particular, needs a push towards liberalization, and we are only requiring the GOT to live up to its commitment.

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